FILE COPY

AUG 7 1946

No. 287

In the Supreme Court of the United States

OCTOBER TERM, 1946

J. ROBERT BAZLEY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and regulations involved	2
Statement	2
Argument	6
Conclusion	19
Appendix	20

CITATIONS

Cases:

Adams v. *Commissioner*, 5 T. C. 351	14
Adams v. *Commissioner*, 155 F. 2d 246	8, 14
Annis Furs v. *Commissioner*, 2 T. C. 1096	14, 15
Bass v. *Commissioner*, 129 F. 2d 300	15
Black, Starr & Frost-Gorham v. *United States*, 39 F. Supp. 108	14
Claude Neon Lights v. *Commissioner*, 35 B. T. A. 424	15
Cogan v. *Commissioner*, 97 F. 2d 996, affirming 36 B. T. A. 639	14
Commissioner v. *Capento Securities Corp.*, 140 F. 2d 382	15
Commissioner v. *Court Holding Co.*, 324 U. S. 331	13
Commissioner v. *Estate of Bedford*, 325 U. S. 283	15, 18
Commissioner v. *Kolb*, 100 F. 2d 920	15
Commissioner v. *Tower*, decided Feb. 25, 1946	13
Dobson v. *Commissioner*, 320 U. S. 489	18
Docherty v. *Commissioner*, 47 B. T. A. 462	15
Electrical Securities Corp. v. *Commissioner*, 92 F. 2d 593	14
Fischer v. *Commissioner*, 46 B. T. A. 999	15
Gregory v. *Helvering*, 293 U. S. 465	8, 10, 11, 13, 14
Griffiths v. *Commissioner*, 308 U. S. 355	13
Handbird Holding Corp. v. *Commissioner*, 32 B. T. A. 238	14
Heady v. *Commissioner*, decided July 24, 1945	14
Helvering v. *Elkhorn Coal Co.*, 95 F. 2d 732, certiorari denied, 305 U. S. 605, rehearing denied, 305 U. S. 676	14
Helvering v. *Gregory*, 69 F. 2d 809	10
Helvering v. *Winmill*, 305 U. S. 79	11
Higgins v. *Smith*, 308 U. S. 473	13
Hill v. *Commissioner*, 66 F. 2d 45	18
Kelley, John, Co. v. *Commissioner*, decided Jan. 7, 1946	13
Lea v. *Commissioner*, 96 F. 2d 55	15
Lusthaus v. *Commissioner*, decided Feb. 25, 1946	13
Marcher v. *Commissioner*, 32 B. T. A. 76	14

Cases—Continued	Page
Minnesota Tea Co. v. *Helvering*, 302 U. S. 609	13
Okonite Co. v. *Commissioner*, 155 F. 2d 248	15
Schoo v. *Commissioner*, 47 B. T. A. 459	15
Taft v. *Commissioner*, 304 U. S. 351	11
Wellhouse v. *Commissioner*, 3 T. C. 363	14
Statutes:	
Internal Revenue Code:	
Sec. 112 (26 U. S. C., Sec. 112)	7, 10, 20
Sec. 115 (26 U. S. C., Sec. 115)	6, 7, 9, 17, 18, 21
Sec. 117 (26 U. S. C., Sec. 117)	7, 23
Miscellaneous:	
H. Rep. No. 179, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 241, 251)	12
H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12–14 (1939–1 Cum. Bull. (Part 2) 554, 563–565)	12, 13
S. Rep. No. 398, 68th Cong., 1st Sess., pp. 14–15 (1939–1 Cum. Bull. (Part 2) 266, 277)	12
S. Rep. No. 558, 73d Cong., 2d Sess., p. 17 (1939–1 Cum. Bull. (Part 2) 586, 599)	13
Treasury Regulations 86:	
Art. 112 (g)–1	11
Art. 112 (g)–2	11
Treasury Regulations 94:	
Art. 112 (g)–1	11
Art. 112 (g)–2	11
Treasury Regulations 101:	
Art. 112 (g)–1	11
Art. 112 (g)–2	11
Treasury Regulations 103:	
Sec. 19.112 (g)–1	10, 24
Sec. 19.112 (g)–2	10, 26
Treasury Regulations 111:	
Sec. 29.112 (g)–1	11
Sec. 29.112 (g)–2	11

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 287

J. ROBERT BAZLEY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 89a–102a) and the dissenting opinion (R. 102a–104a) are reported at 4 T. C. 897. The opinion of the Circuit Court of Appeals (R. 126–136) and the dissenting opinion (R. 137–140) are reported at 155 F. 2d 237.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 16, 1946. (R. 141.) The petition for a writ of certiorari was filed on July

11, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the Tax Court correctly found that the recapitalization of a corporation, pursuant to which the taxpayer exchanged the common stock owned by him for new common stock and debenture bonds, lacked a legitimate corporate business purpose, so that it failed to qualify as a "reorganization" within the meaning of Section 112 (g) (1) (E) of the Internal Revenue Code.

2. If the transaction was not a reorganization within the statutory definition, as both courts below held, whether the Circuit Court of Appeals erred in accepting the Tax Court's finding that the distribution of earnings or profits in the form of debenture bonds was essentially equivalent to the distribution of a taxable dividend under Section 115 (a) and (g) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and Regulations are printed in the Appendix, *infra*, pp. 20–26.

STATEMENT

The pertinent facts found by the Tax Court (R. 90a–95a) may be summarized as follows:

Taxpayer, a resident of Pottsville, Pennsylvania, is the president and treasurer of J. Robert

Bazley, Inc., a Pennsylvania corporation (hereinafter referred to as "Corporation"), organized on May 1, 1930, with an authorized capital of 1,000 shares of a par value of $100 per share. On February 1, 1939, taxpayer owned 798 shares, his wife, Alice H. Bazley, owned 201 shares, and one Alfred Day owned one share of the Corporation's 1,000 shares of outstanding stock. The three stockholders constituted the directors of the Corporation. (R. 90a–91a.)

The Corporation is engaged in a general heavy contracting business. Shortly prior to 1939 it was engaged almost entirely in mining coal by the open-pit method and then first considered going into road building work, which is hazardous and requires considerable working capital. Many road-building contractors have failed. (R. 91a.)

At a special meeting of the Corporation's directors on February 6, 1939, a plan of reorganization was adopted and authority given to increase the capital stock of the Corporation as provided in the plan. The plan recited that on February 1, 1939, the capital of the Corporation was $100,000 and its earned surplus was $855,783.82. It provided for issuance, in exchange for the old stock, of 5,000 shares of new common stock of no par value but with a stated value of $300,000, and $400,000 principal amount of six percent 20-year debenture bonds dated February 1, 1939, callable in whole or in part. The old

stock was to be cancelled. The plan provided for reduction of the earned surplus to $255,783.82 as a result of the increased capitalization and issuance of debenture bonds. (R. 92a–93a.)

On February 16, 1939, the stockholders approved and authorized the proposed plan of reorganization, and on March 6, 1939 the Commonwealth of Pennsylvania approved the amendment to the Corporation's articles of incorporation providing for the increase of its stock. On March 16, 1939, the plan was carried out and the changes in capitalization were entered in the Corporation's books of account. As an incident thereof $200,000 of earned surplus was transferred to capital stock account and $400,000 of earned surplus was transferred to debenture bonds payable account. On March 16, 1939, the 5,000 shares of new stock had a fair market value of not less than $300,000 and the 20-year bonds had a fair market value of not less than $400,000, their face amount. (R. 93a–94a.)

The reasons for adopting the plan of recapitalization were that the stockholders, by obtaining debenture bonds for their stock would receive a more readily marketable and less fluctuating security, in case it was necessary for the estate of a deceased shareholder to liquidate his investment to meet inheritance tax or for other purposes; that if it became necessary for a stockholder to sell some portion of his investment, the bonds

could be sold without reducing the Bazley family's stock control of the Corporation; the contemplated entry into the hazardous business of road construction made it desirable for the stockholders to have bonds, so as to be in a position to share with general creditors to the extent of the debentures, if the business did not succeed; and since the value of the Corporation's plant and equipment ($719,782.41 as of April 30, 1939) was large in relation to its capitalization of $100,000, and since the equipment had been purchased by using funds acquired through accumulating $855,783.07 of earnings and profits, it was thought advisable to reflect a more permanent dedication of these earnings to corporate use, by reducing the surplus available for dividends and transferring a part thereof to capital stock and a part to long-term debt represented by the 20-year bonds. (R. 91a–92a.)

There was no legitimate purpose of the Corporation's business in the issuance and distribution to the stockholders of $400,000 in debenture bonds. (R. 95a.)

In the reorganization the taxpayer received 3,990 shares of new stock and debenture bonds in the principal amount of $319,200 in exchange for 798 shares of old stock. (R. 94a.) In his notice of deficiency for 1939, the Commissioner included in the taxpayer's income the amount of $319,200, representing the fair market value of the bonds of

the Corporation received in exchange for its common stock. (R. 10a, 95a.)

The Tax Court found that, in the absence of a legitimate corporate reason for recapitalizing the Corporation to issue debentures, the distribution of the debentures was not pursuant to a reorganization, as defined by statute; that the distribution was essentially equivalent to the distribution of a taxable dividend; and is taxable as a dividend. (R. 96a–102a.) Five judges dissented. (R. 102a–104a.)

The Circuit Court of Appeals sitting en banc, affirmed (R. 126–136), two judges dissenting (R. 137–140).

ARGUMENT

The judgment of the Circuit Court of Appeals is correct and is not in conflict with any other decision, so as to warrant further review of the case by this Court.

The opinion of the lower court (R. 126–136) points out that the distribution of the Corporation's debenture bonds segregated earned surplus in the face amount of the bonds and represented a distribution of its accumulated earnings and profits (see Section 115 (b) of the Internal Revenue Code (Appendix, *infra*)); that the distribution conforms to the definition of a dividend in Section 115 (a) (Appendix, *infra*); and that the Tax Court's findings that the distribution of the bonds was essentially equivalent to the distri-

bution of a taxable dividend and that the bonds, to the extent of their value (Section 115 (j) of the Code, Appendix, *infra*), are taxable as a dividend under Section 115 (g) of the Code (Appendix, *infra*), are fully warranted. The court then considered whether the circumstance that the distribution of the debenture bonds was cast in the form of an exchange pursuant to a recapitalization operated to relieve the stockholders of paying a tax on the distribution as a dividend.[1] It concluded that, as the Tax Court

[1] If the exchange was made pursuant to a plan of recapitalization which is to be given effect as a reorganization for tax purposes, Section 112 (b) (3) of the Internal Revenue Code (Appendix, *infra*) would apply to prevent any present recognition of the gain on receipt of the bonds. And as the Tax Court pointed out (R. 102a), when the bonds were sold, exchanged, or retired, the gain thereon would be taxed not as a dividend, but as capital gain with the accompanying limitations on taxability. See Section 117 (b) and (f) of the Internal Revenue Code (Appendix, *infra*). Thus, the distribution of profits would escape taxation as a dividend. It is true that, if the transaction were to be recognized as a reorganization, under Section 115 (h) (Appendix, *infra*) the issuance of bonds would not be deemed a distribution of earnings for tax purposes and the earnings would remain available for subsequent dividends; yet by the repeated device of issuing debentures in a so-called recapitalization, not required by business reasons of the corporation, and then redeeming them, a corporation could in fact distribute all its earnings periodically, so that it would never have to declare any dividend, or at most would have to declare only small dividends, which would be recognized as a reduction of earnings by Section 115 (h) and be taxed as a dividend. This possibility furnishes a persuasive reason for concluding that only legitimate recapitalizations required by business

found the recapitalization was not induced by any legitimate business reason of the corporation, it had no substance for tax purposes, and, disregarding form, the distribution of bonds was to be treated as what it was in fact, a means of distributing corporate earnings and hence a dividend.[2]

1. Taxpayer seeks a writ of certiorari on the ground principally (Pet. 5–6, Br. 13–14) that the conclusion of the lower court that there was no "reorganization" as intended by the statutory definition of that term involves an unjustified construction of this Court's reasoning in *Gregory v. Helvering*, 293 U. S. 465. We believe that decision laid down the broad principle that a transaction cast in the form of a reorganization does not fall within the intent of the statutory definition of reorganization unless it occurs pursuant to a plan dealing with the reorganization of the corporate business. This manifestly would exclude a plan of recapitalization devised solely to serve some personal advantage of the stockholders of a closely held corporation and having no relation to the corporation's business, for it was a purpose of this kind which was condemned in the *Gregory* case. Three of the reasons for the

---

exigencies of a corporation are to be given effect as statutory reorganizations.

[2] The same holding was made by the lower court in *Adams v. Commissioner*, 155 F. 2d 246, now pending before this Court on petition for writ of certiorari, No. 209,

recapitalization here, as the Tax Court's findings and discussion show (R. 91a–92a, 99a–102a), were solely personal to the taxpayer and his wife, having no relation to the needs of the corporation's contracting business, and the fourth was not a legitimate corporate business purpose.[3] Indeed, the Tax Court inferred that the stockholders "may well have endeavored to establish a foundation for participating in the corporate profits without subjecting the distributions to taxation as dividends" (R. 102a), an objective closely analogous to that in the *Gregory* case. Taxpayer does not challenge the Tax Court's findings of purpose or contend that they include a corporate business purpose, if such a purpose is required. (Pet. 2–3, 5.)

[3] This fourth purpose was the desire to reflect a more permanent dedication to corporate use of the $855,783.07 of accumulated earnings, already used to purchase equipment, by reducing surplus available for dividends and transferring a portion to capital stock and to the debenture bond debt. (R. 92a.) But the Corporation had the same use of the earnings, invested in equipment, regardless of the account in which the earnings stood on its books, and as the Tax Court pointed out (R. 100a), the desire to remove the earnings as a source for dividend payments is not a legitimate business purpose of the Corporation, since it involves an attempted circumvention of Section 115 (a) and (b) which regard such a segregation of accumulated earnings as a dividend. Thus, this purpose also can be viewed as one personal to the stockholders because it was an effort to allocate earnings to them without occasioning the tax consequences which would ensue if the earnings were distributed directly.

Nor do we understand that the *Gregory* decision rests on the premise that the transaction there was only a "fraud" or a "sham." As this Court said (p. 469) a "new and valid corporation was created." The transactions were a sham only in the sense that they "were no part of the conduct of the business of either or both companies." *Helvering* v. *Gregory*, 69 F. 2d 809, 811 (C. C. A. 2d).

Accordingly, we believe the lower courts correctly relied on the decision of *Gregory* v. *Helvering, supra*, in concluding that the recapitalization was not a reorganization within the intent of the statutory definition of that term. But the holding was also required by the long standing administrative interpretation as to the intent of the statutory definition of reorganization and by legislative expressions as to the meaning of the term. Sections 19.112 (g)-1 and 19.112 (g)-2 of Treasury Regulations 103 (Appendix, *infra*) provide that the readjustments effected in the consummation of a plan of reorganization under Section 112 (g) of the Code (Appendix, *infra*), which includes reorganization by recapitalization, must be required by "business exigencies" and "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."[4]

[4] These requirements qualify the whole discussion of reorganization in the Regulations. Thus, the example given

These provisions were first contained in Articles 112 (g)–1 and 112 (g)–2 of Treasury Regulations 86, promulgated under the Revenue Act of 1934, approved February 11, 1935, and have been continued without change since that time.[5] Under familiar principles Congress is deemed to have approved them by reason of the reenactment of the statutory definition without amendment in this respect. *Helvering* v. *Winmill*, 305 U. S. 79; *Taft* v. *Commissioner*, 304 U. S. 351. The lower court approved these Regulations as reasonable and a valid exercise of the rule-making power. As it stated, it would have had to hold the Regulations invalid, in order to reverse the Tax Court, since the recapitalization was not [illegible] business exigencies, nor was it [illegible] tinuance of the corporate busine[illegible]

The Regulations incorporate [illegible] Congress, as well as what we under[illegible] been the view of this Court in [illegible]

in the Regulations quoted by taxpayer (Pet. [illegible], as to what constitutes a recapitalization, has implicit in it the requirement of a corporate business exigency as causing the exchange of unissued authorized preferred stock for outstanding common stock.

[5] Articles 112 (g)–1 and 112 (g)–2 of Treasury Regulations 94, promulgated under the Revenue Act of 1936, and of Treasury Regulations 101, promulgated under the Revenue Act of 1938; Sections 29.112 (g)–1 and 29.112 (g)–2 of Treasury Regulations 111, promulgated under the Internal Revenue Code for application to years beginning after December 31, 1941.

vering, supra: H. Rep. No. 179, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 241, 251) and S. Rep. No. 398, 68th Cong., 1st Sess., pp. 14–15 (1939–1 Cum. Bull. (Part 2) 266, 277) stated, in reporting the Revenue Bill of 1924, that the Congressional policy was to exempt from tax the gain on reorganization exchanges so that—

> ordinary business transactions will not be prevented on account of the provisions of the tax law.

Again, in connection with the pending Revenue Bill of 1934, H. Rep. No. 704, 73rd Cong., 2d Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 554, 564) stated that—

> the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganizations to (1) statutory mergers and consolidations; (2) transfers to a controlled corporation, "control" being defined as an 80-percent ownership; and (3) changes in the capital structure or form of organization.
>
> By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, *legitimate reorganizations, required in order to strengthen the financial condition of the corporation, will be permitted.* Furthermore, the retention of the other reorganization provisions will prevent large losses

> from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise *which are substantially the same as their original investments.* [*Italics supplied.*]

S. Rep. No. 558, 73d Cong., 2d Sess., p. 17 (1939–1 Cum. Bull. (Part 2) 586, 599), is consistent. As the lower court pointed out (fn. 12, R. 133), the statutory reorganization and exchange provisions were amended and retained in the 1934 Act, instead of being abolished as a result of attempted abuses, in part because the courts had shown a tendency to give effect to the substance of a transaction, even though cast in the form of a reorganization.[8] See for a full discussion H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12–14 (1939–1 Cum. Bull. (Part 2) 554, 563–565).

As has been seen, the concept that a reorganization to fall within the statutory definition must be a commercial or financial transaction undertaken in the interests of the corporation's business

[8] Apart from the *Gregory* case, this Court has consistently treated the substance of a transaction as determining the tax consequences, rather than the form in which it occurred, where the form chosen was not due to business reasons. *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Higgins* v. *Smith*, 308 U. S. 473; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; cf. *Commissioner* v. *Tower*, decided February 25, 1946 (1946 P-H, par. 72016; *Lusthaus* v. *Commissioner*, decided February 25, 1946 (1946 P-H, par. 72015); *John Kelley Co.* v. *Commissioner*, decided January 7, 1946 (1946 P-H, par. 72009).

is not a new development as taxpayer asserts. (Br. 14–16.) To be sure, the precise factual situation in which a so-called recapitalization was brought about solely to serve the private purposes of the stockholders, without relation to the corporate business, has only recently been presented. See *Wellhouse* v. *Commissioner*, 3 T. C. 363; *Adams* v. *Commissioner*, 5 T. C. 351, affirmed, 155 F. 2d 246 (C. C. A. 3d), pending on petition for writ of certiorari, No. 209, this Term; *Heady* v. *Commissioner*, decided July 24, 1945 (1945 P-H T. C. Memorandum Decisions, par. 45,261), pending on appeal (C. C. A. 7th); cf. *Annis Furs* v. *Commissioner*, 2 T. C. 1096. Both the courts and the Tax Court in other factual situations have recognized the principle and applied it to other forms of reorganization where no corporate purpose was shown, at least since the promulgation of the Regulations and the decision in *Gregory* v. *Helvering*, 293 U. S. 465.[7] In the cases in which it has been found that a statutory reorganization occurred, the facts disclosed that the arrangement was undertaken in part for corporate business or

[7] See e. g. *Helvering* v. *Elkhorn Coal Co.*, 95 F. 2d 732 (C. C. A. 4th), certiorari denied, 305 U. S. 605, rehearing denied, 305 U. S. 679; *Cogan* v. *Commissioner*, 97 F. 2d 996 (C. C. A. 2d), affirming *per curiam*, 36 B. T. A. 639; *Electrical Securities Corp* v. *Commissioner*, 92 F. 2d 593 (C. C. A. 2d); *Black, Starr & Frost-Gorham* v. *United States*, 39 F. Supp. 109 (C. Cls.); *Marchetti* v. *Commissioner*, 32 B. T. A. 76; *Handbird Holding Corp.* v. *Commissioner*, 32 B. T. A. 238, 249.

financial reasons; hence, whether or not the necessity for a corporate purpose was specifically discussed, the cases are consistent with the rule that a purpose germane to the corporate business is essential to bring a transaction within the statutory definition of reorganization.*

In fact, the taxpayer does not assert that any case is in clear conflict with the decision below, but only that the decision is "irreconcilable" with *Commissioner* v. *Kolb*, 100 F. 2d 920 (C. C. A. 9th). (Pet. 7.) In that case the court stated that the reorganization had business purposes, both for the corporation and its stockholders, listing ten such purposes, but it did not hold that a purpose to benefit stockholders only would be sufficient, in the absence of purposes furthering

* For example, see *Okonite Co.* v. *Commissioner*, 155 F. 2d 248 (C. C. A. 3d); *Commissioner* v. *Capento Securities Corp.*, 140 F. 2d 382 (C. C. A. 1st); *Büss* v. *Commissioner*, 129 F. 2d 366 (C. C. A. 1st); *Lea* v. *Commissioner*, 96 F. 2d 55 (C. C. A. 2d); *Annis Furs* v. *Commissioner*, *supra*; *Fischer* v. *Commissioner*, 46 B. T. A. 999, dismissed June 3, 1943 (C. C. A. 6th); *Schoo* v. *Commissioner*, 47 B. T. A. 459; *Docherty* v. *Commissioner*, 47 B. T. A. 462; *Claude Neon Lights* v. *Commissioner*, 35 B. T. A. 424, 428. In *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, as in many cases, the purpose of the recapitalization was to eliminate accumulated dividends on preferred stock so as to better the corporation's financial position. We dispute taxpayer's claim (Br. 15) that the Tax Court has sustained recapitalizations clearly for the sole benefit of stockholders. The cases cited (fn. 4) do not sustain the claim. In all of them a corporate reason for the transaction is either disclosed in the facts and discussion, or is assumed.

the corporation's business also. The lower court here did not hold, nor do we contend, that the reorganization must be *solely* for the corporation's benefit, without any advantage to the stockholders.

The dissenting opinion below on which taxpayer relies (Br. 18–19) is based largely on the view that a corporation and its stockholders may not be disassociated and that a transaction which promotes the stockholders' interest has a purpose from the corporation's point of view. While it may be true that the general purpose of a corporation is to carry on its business for the ultimate benefit of its stockholders, it does not follow that the corporate purposes of a company engaged in a commercial business enterprise (heavy contracting) include the carrying out of a capital change merely because its two stockholders desire to change their securities for personal reasons. Even assuming, *arguendo* only, that such a transaction could in a loose sense be construed as having a "corporate" purpose, it is not one brought about by business exigencies, germane to the corporate business, or one which strengthens the financial condition of the business enterprise. Not only is a corporate purpose required, but it must be a purpose connected with the corporation's business to fulfil the statutory intent as expressed by this Court, by Congress, and by the Regulations.

The corporate business purpose test is not vague and unworkable, as taxpayer argues. (Br. 17–18.) Whether the required purpose motivated a particular transaction is a factual question. In most cases the facts will clearly disclose whether a recapitalization serves a corporation's business interests in some respect or solely the unrelated and private interests of its stockholders, but in doubtful cases the question, like other disputed questions of fact, can be resolved by the trier of facts. The Tax Court has not expressed the view that the test is unworkable.

2. The taxpayer seeks a writ of certiorari on the ground also (Pet. 8, Br. 19–22) that the lower court "changed" the finding of the Tax Court that the debentures and new stock were received in exchange for the old stock, and maintains that, even though there was no statutory reorganization so that the receipt of the bonds would be tax-free, the income realized on receipt of the bonds must be taxed as a capital gain, rather than as a dividend, because they were received in an "exchange."[9] The Tax Court did indeed find that the distribution of the bonds was cast in the

[9] The result of this contention would be that the distribution of earnings in the face amount of the bonds would forever escape taxation as a dividend. Section 115 (h) would not apply to keep the earnings intact for future distribution as dividends for tax purposes, since the distribution of bonds would be recognized as a taxable one.

form of an exchange pursuant to a recapitalization but its view was that in substance the transaction was a medium for distributing the corporate earnings. It disregarded the form and looked through to substance, treating the arrangement for tax purposes as a dividend distributing transaction, rather than an exchange. The lower court, consistently with *Dobson* v. *Commissioner*, 320 U. S. 489, accepted this view as warranted by the facts. It did not alter the finding that the bonds were received in an exchange; instead, it agreed with the Tax Court that substance, rather than form, governs the tax consequences. Taxpayer cites no authority compelling the holding that a distribution which is in substance a dividend as defined in Section 115 (a) cannot be so treated under Section 115 (g), simply because it is made in the form of an exchange.[10] Cf. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283.

---

[10] Taxpayer does not argue that Section 115 (g) can not apply to a distribution of property in cancellation of old stock, which is cast in the form of an exchange. In any event, the section is not so restricted. It in terms applies to any cancellation of stock made under such circumstances as to be the equivalent of a dividend and is not confined to such cancellations as fall within the statutory definition of a partial liquidation. (See Section 115 (i) (Appendix, *infra*).) It is immaterial under Section 115 (g) that simultaneously with the cancellation of the old stock a different class of stock was issued. *Hill* v. *Commissioner*, 66 F. 2d 45 (C. C. A. 4th).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.
DOUGLAS W. MCGREGOR,
Assistant Attorney General.
SEWALL KEY,
HELEN R. CARLOSS,
HELEN GOODNER,
Special Assistants to the Attorney General.

AUGUST 1946.

APPENDIX.

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchange Solely in Kind.*—

* * * * *

(2) *Stock for Stock of Same Corporation.*—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) *Stock for Stock on Reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(g) [as amended by Section 213 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862]

Definition of Reorganization.—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its vot-

ing stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected. (26 U. S. C., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * * *

(26 U. S. C., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * * *

(b) *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has

been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

* * * * *

(f) *Retirement of Bonds, Etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * * *

(26 U. S. C., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.112 (g)–1. *Purpose and scope of exception of reorganization exchanges.*—*Purpose*: Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a

continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. * * * In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

* * * * *

The provisions of the Internal Revenue Code referred to in the preceding paragraph of this section are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must

provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

SEC. 19.112 (g)-2. *Definition of terms.*—

* * *

* * * * *

The term "plan of reorganization" has reference to a ~~consummated~~ transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in section 112 (g) (1). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE